THE EXEMPTION OF LIFE INSURANCE FUNDS FROM TAXATION

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The discussion preceding the enactment of the federal income tax law in 1913 reopened an issue on which life insurance officials and legislators have disagreed for years. Though insurance companies have contended that life insurance funds do not offer a legitimate field for taxation, they have been called upon yearly to pay larger and larger amounts in taxes to the various states in which they operate. The bill introduced in Congress offered no exemption to an individual who protected his dependent family through life insurance from becoming public charges at his death, or who, by the same agency, provided for his own old age. Nor did it exempt the income of the life insurance company, the funds of which are a standing guarantee against family and old age dependency.

The discussions of this bill, like most controversies over the question of taxing life insurance funds, have consisted in dogmatic assertions on both sides unattended by any attempt at scientific analysis that would give a basis for testing the arguments. It is doubtless true that most life insurance men accept without proof the statement that life insurance funds should never be subject to general taxation; it is equally true that legislators, in their search for ways and means, are inclined to choose the method which offers easy collection and has the least injurious effect on party success, regardless of the scientific character of the taxation problem.

Any permanent settlement of this controversy in the near future is unlikely. With the extension of government activities there is necessity for increasing revenue, and new laws have a tendency to reach untaxed sources of wealth. These laws are often passed, however, without being submitted to the test of a really adequate theory. Those who oppose the taxation of life insurance funds, having a perfectly good case to defend, have too often devoted their energies to attacks on particular laws and have not made clear

the underlying reasons why life insurance funds should receive special consideration.

BASIC REQUIREMENTS OF A TAX SYSTEM

The statement of principles on which life insurance taxation shall be based is not a pleasant task. One faces two bitterly opposing camps, either ready to fall upon the first heterodox statement and to cry "traitor." It is a profitable task, however, if agreement is ever to replace the present conflict of opinion.

Taxes are general or specific. Taxation of any kind is justified on the ground that administration of government results in benefit to the governed. In a broad sense, the function of government is the care of the health, morals and well-being of its subjects and the funds necessary for the conduct of such activities can be obtained by general taxation. The relationship between work performed and revenues obtained is indirect as, for instance, where a tax levied on property is used for the supervision of public health or for the support of judicial tribunals. In extending the field of government, it has become increasingly necessary to carry on special activities and the revenues for such purposes are collected directly from those benefited and should cover only the cost of service rendered. Thus the federal government conducts the postal service and collects two cent for each letter carried. The feeling that the postage tax should not be greater than the cost of this service is reflected in the demand for penny-postage. The government is likewise called upon from time to time to supervise particular institutions and the cost of such supervision may be charged directly.

With government thus functioning as general and specific—for the benefit of all, and for the benefit of special classes of the governed—it is proper to distinguish two correlative types of taxation: general taxation, to pay costs of government activities in the benefits of which the whole people share; and specific taxation, to cover the costs of benefits accruing to a limited group.

The justice of any system of taxation may be tested on different grounds in so far as we are dealing with these two fields of government enterprise. It may be accepted as a working principle that the conduct of specific operations such as carrying the mails shall be paid for by those who use the mails, or that specific institutions which receive the benefit of government supervision shall be taxed

directly to pay its cost. Little disagreement with this principle will be found. An equitable system of general taxation is much more difficult to formulate. Adam Smith stated its fundamental premise when he said "The subjects of every state ought to contribute to the support of government as nearly as possible in proportion to their respective abilities: that is, in proportion to the revenue which they respectively enjoy under the protection of the state."[1] This principle is accepted by John Stuart Mill, and in his elaboration of it he interprets it to mean that "equal sacrifices ought to be demanded from all."[2]

General taxation should be levied upon surplus. It is true that much popular misunderstanding results from the attempt to explain these doctrines in current phraseology, and clearness is in no way attained by a study of tax systems in the United States. It is quite certain, however, that if Mill were restating his doctrine at the present time he would do so in terms of the standard of living. He would justify any tax system in accordance with the way in which it might affect individual incomes. A tax falling upon the person whose income is insufficient, or only just sufficient, to maintain physical existence and rear a family would be destructive and therefore socially undesirable. All taxes should fall, in so far as possible, on those who enjoy incomes in excess of this amount. Fortunately, the decision as to what is a minimum standard of living need not enter the present argument. The sociologists may be permitted to establish the limit and we may agree not to tax individuals whose incomes fall below this mark. We may say with certainty that the government is justified in taxing the man whose annual income is $100,000; but the advisability of taxing a $2.00 per day wage may await the determination of the minimum standard.

While the amount necessary to maintain this standard need not be stated for the present argument, the factors which it includes do require statement. It means more than the food, clothing, lodging and recreation supplied by current income. It requires provision for times when income may cease through death, sickness, disability or old age. Recent developments of the idea of family responsibility include the belief that the man whose income may cease with death, disability or superannuation must lay aside certain

[1] *Wealth of Nations*, Book V, Chap. II, Part I.

[2] *Principles of Political Economy*, Book V, Chap. II, Sec. 3.

amounts from his weekly or yearly income for insurance or annuities to provide for family needs, should any of these catastrophies occur. Society benefits if all persons whose incomes fail to satisfy these minimum requirements are exempt from taxation. In Mill's own words, "The principle . . . . of equality of taxation, interpreted in its only just sense, equality of sacrifice, requires that a person who has no means of providing for old age, or for those in whom he is interested, except by saving from income, should have the tax remitted on all that part of his income which is really and bona fide applied to that purpose."[3] Indeed, he goes further and says that, were it possible to administer the tax, it should be based on expenditures and all savings should be exempted. But, since this cannot be done without great liability to fraud the next best thing is to exempt those amounts which "different classes of contributors ought to save."[4]

It is at this point that Mill's theory overreaches itself. Present-day social philosophy interprets his doctrine of "equal sacrifices from all" to mean the exemption of all persons whose incomes will not purchase the present necessities of life and insurance against loss of income in the future, and the taxation of all who enjoy a *surplus income* beyond these minimum requirements. This is thoroughly consistent with the doctrine originally propounded by Adam Smith, and accepted by Mill, of taxing those who have ability to pay. The taxation of expenditures only opens the way for the transmission of large unearned incomes to heirs. Savings should be encouraged in so far as they are used for the education and equipment of children in order to give them the best possible opportunity to develop their talents and make of them socially useful citizens. But savings intended to furnish children with an unearned income that will support them in leisure and idleness may be taxed with wholesome social effect. Unearned incomes are limited by the imposition of an inheritance tax; and it is proper to limit them also in the process of accumulation by a tax on surplus income.

Application of these principles to the taxation of life insurance. The theory of taxation here outlined may be applied to the taxation of life insurance funds in the following manner. Specific taxation to pay the expenses of government supervision of the life insurance

[3] Mill: *Principles of Political Economy,* Book V, Chap. 2, 4.
[4] *Ibid.*

companies is fully justified so long as the tax does not exceed the expenses of such supervision. Taxation for general government purposes is justified only in so far as life insurance funds represent something more than a sufficient provision of the necessities for maintaining a proper standard of living and providing minimum savings for dependents and for old age.

There are two direct means of taxing life insurance funds: a tax on life insurance corporations and a tax on an individual's provision for life insurance. The corporation may be taxed on its assets, on its premium income, on its investment income, or on its profits or surplus. An individual's provision for life insurance may be taxed while being accumulated or when paid to beneficiaries. It is taxed in the process of accumulation when a law taxing income fails to exempt those portions of income used for the purchase of insurance or old age protection; it is taxed after being accumulated, if the income tax law fails to exempt the proceeds of life insurance contracts when paid to beneficiaries in immediate cash or in installments.

Taxation of life insurance companies. Taxes on life insurance corporations are justified in so far as they pay reasonable expenses of government supervision; more than this amount may not, in strict theory, be collected unless life insurance funds comprise something more than necessary savings for dependency and old age provision. The company which operates on the stock plan and each year diverts a portion of its funds for the payment of dividends on stock is to this extent more than an insurance and savings institution and may not object to the imposition of a corporation tax on the part of its funds so diverted. This would be a tax on the "gains or profits of trade," in the words of the English income tax law. A purely mutual insurance company has no such *profits of trade* and either must not be taxed at all or on a different basis. If we were to accept fully Mill's rule that all savings be exempt from taxation, there would be no basis whatever for taxing the mutual company; but the principle stated on page 126 and the principle that has gained acceptance in English tax laws is to exempt savings only up to a certain minimum and to tax all over this amount. If this rule is accepted as a basis for taxing individual incomes it must be accepted likewise in the case of corporate incomes. The tax authorities are then justified in imposing a tax upon all life insurance corporations

whose assets represent provision for any individual beyond the minimum standard accepted. It is plainly impossible to tax such corporations in strict accordance with the amount of excess savings reflected in their assets. The method adopted will necessarily be only a rough approximation to theoretical requirements. Taxes on assets, on premium income or on investment income are justified, for purposes other than the cost of government supervision, only on the ground that savings in excess of minimum requirements are reflected in the company's assets. The measure of the stringency of such taxation should be the degree to which it discourages saving for dependents or for old age requirements.

Taxation of individuals. An individual provides for life insurance needs by devoting a portion of his income to the purchase of insurance and annuities. A system of taxation based on the principle of taxing surplus income recognizes a minimum provision for these needs as one of the necessaries of life and therefore not taxable. It is not a sufficient answer to say that the need for saving for dependents or old age is met by the personal exemption granted small incomes by the income tax. The point of this exemption is that no income below this limit is to be taxed no matter in what way it is spent. If, then, it is desirable to encourage citizens to make their own provision for old age or for dependents, it must be done by a further exemption.

The proceeds of insurance policies may be paid to beneficiaries in a single cash sum, in a fixed number of installments or as an annuity for life. It would be entirely improper to consider the receipt of the face value of an insurance policy at maturity as part of a single year's income and to tax the entire amount as such. It should be taxed, if at all, as an inheritance. Furthermore, the failure to tax the sum insured upon its payment to the beneficiary does not exempt it completely from taxation, for it is usually invested and emerges again as income.

Where the sum received is paid at maturity in a fixed number of installments or as a life annuity, the question is raised whether it is not incorrect to consider the entire amount of each periodic payment as income and therefore taxable. The claim is justly made that the amount received is only income in part; that the major portion is a return of the principal left with the insurance company. The federal income tax law recognizes this distinction between

principal and interest in an annuity income and modifies the method of assessing income tax on annuities in conformity with the idea that the principal should be exempt. This procedure does not accord with the theory that only necessary provision for the necessities of life should be exempt and that all surplus above this amount should be subject to tax. Under such an interpretation of an annuity income, a person might invest in an annuity of several hundred thousand dollars per year and enjoy it largely free from taxation, whereas the maximum of other incomes exempt from tax in our federal law is four thousand dollars. On the basis of assessing taxation against surplus, the distinction between principal and income in a taxable annuity may not be defended, and the tax shall be assessed on the entire amount of the periodic payment if above the limit for exemption.

There is no logical basis for the exemption from taxation of that part of an annuity which is principal. Like so many of our tax laws (in fact, the idea may be applied to almost any law) this method of dealing with annuities is probably based on some early decision of a purely technical character. Some one claimed exemption from an income tax on the ground that the principal of an annuity is not income, and the decision became a precedent. This is exactly what has happened under the federal income tax law of 1913. This law did not make clear its purpose in taxing annuities and the demand was shortly made for a distinction between principal and income and the exemption of the former from tax. The method of administering the law was finally cleared by Treasury Decision number 2151, which stated: "The amount paid under a life insurance, endowment or annuity contract is not income when returned to the person making the contract, either upon the maturity or surrender of the contract; but the amount by which the sum received exceeds the sum paid and coming into the hands of the person making the contract and payment is income."

Now that the precedent is established, the procedure is defended on other and different grounds. Probably the favorite argument is that the taxation of the principal of an annuity is a direct discouragement to saving. A great deal of bombast is wasted on this idea, and it is easy to raise a cry in favor of the "poor widows and orphans"; but we must not be unmindful of the fact that, in the long run, the best friend of life insurance is the one who builds that

institution on the surest foundation. It is the feeling of the writer that a tremendous mistake has been made in our income tax law in the emphasis placed on the interpretation of an annuity income, while the fundamental problem has been entirely neglected, namely, the exemption of that part of yearly income which is spent for life insurance or annuity *needs*. The way to encourage saving for these purposes is to release from taxation the money spent in life insurance premiums. The taxation of a large annuity income is taxing the fund after it has been accumulated, and it is difficult to see how this will result in decreased provision for life insurance needs. Furthermore, the exemption of such income from taxation violates the fundamental premise that taxation should be levied on surplus.

SUMMARY

To summarize the preceding discussion, governments function in two ways,—certain activities benefit the whole people; others, only special groups or classes. Taxation therefore should be general or specific in so far as revenue is used for the general good or for selected classes. Specific taxation shall aim to pay the expense of service rendered and no more and shall be levied upon those for whom the service is performed; general taxation shall be levied upon all who have "ability to pay" and this class will include only those whose incomes more than satisfy the requirements of a decent standard of living, including necessary provision for dependents in case of death, disability or sickness and for one's self in case of forced or voluntary retirement.

This theory may be used as a test of the adequacy of methods of taxing life insurance companies and individuals. The companies shall be taxed directly to pay the cost of government supervision. Further levies on them are general taxation and are supported on the ground that the assets of the companies reflect provision on the part of some policyholders for more than minimum insurance needs, that life insurance companies, in other words, have become a depository for surplus income of men of wealth. Companies operating on the stock plan and paying dividends to stockholders may be taxed further on some basis of capitalization or of dividends paid to stockholders.

In taxing individuals, the basic requirement of the theory is that all persons shall be relieved from the burden of general taxation on

that portion of income needed to guarantee a decent standard of living and to purchase a liberal amount of insurance protection against common hazards. As the federal income tax law sets a limit of $3,000 income on which no one is taxed, so it should make a second exemption of income spent on insurance premiums.

The proceeds of matured policies shall be taxed on the principle of an inheritance or an income. If paid in a lump sum, and its amount be sufficient for taxation as an inheritance, it shall be so taxed, but never as an income. If it be paid in installments or as an annuity, it is in effect an exchange of capital for an income and shall be taxed as income.

LIFE INSURANCE TAXATION IN THE UNITED STATES

Existing tax laws in the United States may be examined in their application to life insurance funds and may be tested by the principles here stated. Generally speaking, life insurance is subject to tax by one or more of three governmental bodies, the federal government, the state and the municipality. The first two will be considered in this paper.

State taxes. The state, being the governing authority with the power and duty of supervising life insurance corporations, taxes them with the primary purpose of paying the costs of supervision. This is usually done by a tax on premiums collected within the state. The rate charged varies from one to three per cent with different states. Sometimes it is charged on gross premiums; in other cases, gross premiums less death losses; and frequently, in the case of participating policies, on gross premiums less dividends. A few states have shown liberality by defining "premiums," in the meaning of the law, as gross premiums less dividends. On the other hand, where legislatures have not shown this liberality, the courts in several instances have done so. The United States Court of the District of Columbia and the Court of Common Pleas of Dauphin County, Pennsylvania, have held that dividends do not constitute income and are not therefore subject to taxation.

The tendency of state taxes on premiums in recent years has been upward in both the United States and Canada. Thus Alabama increased the tax in 1908 from one to two per cent; the rate in Virginia has been increased since 1911 from one to two and one quarter per cent; in Quebec a rate of one per cent was changed in

1906 to one and three-quarters per cent.[5] Similar instances could be cited in great number. It is generally conceded that a tax of one per cent on premiums would pay all costs of state supervision of life insurance companies. The states have therefore departed from the original purpose of the premium tax and are using it as a means of collecting revenues for general governmental purposes. This tendency is rightly viewed with much alarm by life insurance officials, since the main reason for the increasing levies seems to be the ready availability of life insurance funds for taxation and the ease with which the tax is collected.

License fees paid by insurance companies for the right to do business in a state, for the right of each agent to solicit, for the filing of reports, and the like, constitute a not unimportant source of state revenue in addition to premium or other taxes.

Very few states have passed income tax laws, hence the problem of direct taxation, by the states, of an individual's insurance premiums or the value of matured policies does not often arise. The Massachusetts income tax law makes no reference to life insurance funds. The Wisconsin law allows as deductions from the taxable income of individuals "all insurance . . . . received in payment of a death claim by an insurance company" but holds endowments or other insurance paid to the insured during his lifetime to be taxable on the excess received over the amount paid for insurance. The inheritance tax law of Wisconsin, however, states that insurance payable on the death of any person shall be considered a part of his estate for the purposes of the tax and shall be taxable to the persons entitled thereto. A direct application of the principle of taxing all surplus above current necessities of life and mimimum insurance needs is difficult with these laws. While the Wisconsin legislature has apparently considered the question of exemption in case of life insurance funds, this consideration has not been based on an adequate comprehension of the issues involved.

State taxes on life insurance funds were thus assessed, in the beginning, apparently for the sole purpose of paying the cost of supervising life insurance corporations. Had their scope never been extended beyond this point it is doubtful if the agitation against life insurance taxation would have occurred. But the huge assets of the

[5] These facts are taken from an article by James M. Craig in *Transactions Actuarial Society of America*, 16: 1–7.

companies have been an open book, and the objections raised by insurance officials have not had sufficient political effect to be heeded. Hence the tendency to increase these assessments has continued to the present time, and life insurance companies are paying annually to the state governments large sums of money for general governmental purposes.

Federal taxes. The present federal income tax law was passed in September, 1916. Its method of taxing individuals and corporations best shows the extent to which revenue authorities have grasped the significance of the problem of dependency and old age provision with reference to the imposition of a tax. That portion of the federal law which refers to life insurance companies provides that "there shall be levied . . . . *upon the total net income received* . . . . in the preceding calendar year . . . . by every . . . . insurance company . . . . a tax of two per centum upon such income." "Net income" is ascertained, in the case of a life insurance company, by deducting from the gross income from all sources (1) all ordinary and necessary expenses; (2) all losses (this item including funds necessary to satisfy reserve requirements, and sums paid during the year on policy and annuity contracts); (3) dividends paid or credited to individual policyholders; and (4) taxes "imposed by the authority of the United States, or its territories, or possessions, or any foreign country, or under the authority of any state, county, school district or municipality" except those assessed against local benefits. Here is a tax imposed by federal authority for general government purposes on the net income of life insurance corporations, a definite recognition of the fact that the assets of these companies represent funds in excess of the minimum requirements for life insurance and old age provision for their individual policyholders. So long as companies issue policies for large amounts, aggregating thousands of dollars, to single individuals they may expect that no defense against the imposition of such a tax will be sustained. Should they limit the size of their contracts as do fraternal companies they could sustain an excellent plea for exemption from the provisions of the corporation tax. So far as is known to the writer, the life insurance companies did not oppose serious objections to the imposition of this tax.

Section 407 of the 1916 Act imposes an excise tax on "every corporation, joint stock company or association . . . . organized

in the United States for profit and having a capital stock represented by shares, and *every insurance company* . . . . organized under the laws of the United States . . . . *equivalent to 50 cents for each $1,000 of the fair value of its capital stock*, and in estimating the value of capital stock the surplus and undivided profits shall be included." An exemption of $99,000 is allowed from the capital stock as above defined. This paragraph further states that "every corporation, joint-stock company or association, *or insurance company* . . . . *organized for profit* under the laws of any foreign country and engaged in business in the United States" shall likewise pay an excise tax. It is clear that a mutual life insurance company organized in a foreign country is exempt from the provisions of this tax, but it is not equally clear that a mutual company organized in the United States is so exempt; for the section quoted, referring to domestic companies reads "Every corporation . . . . organized for profit, ... *and every insurance company.*" The tax on domestic companies, however, is upon "the fair average value of the capital stock," and not upon surplus and undivided profits. It is difficult to see, therefore, how mutual life insurance companies can be taxed under this section. The excise tax, in this case, is assessed on profits available to stockholders. Incidentally, this tax may accelerate the movement for the mutualization of all life insurance.

The federal tax on individuals applies to all incomes above $3,000, or in the case of married persons, $4,000. The statute ought to grant a further exemption of income used for the purchase of insurance or old age protection, but apparently Congress did not consider the matter. It seems strange that, with all the pressure brought to bear on Congress by life insurance interests prior to the passage of the 1913 law, this important provision was not included. Here, if anywhere, was the opportunity, by a proper exemption, to offer the greatest encouragement to individuals to make provision for insurance needs. But Congress missed its opportunity both in 1913 and in 1916. In contrast, one of the conspicuous features of the English income tax law grants exemption of income to the amount of £100 if spent on life insurance and annuities.

Special consideration is given to life insurance funds by the income tax law in the paragraph exempting from the tax "the proceeds of life insurance policies paid to individual beneficiaries upon

the death of the insured" and "the amount received by the insured, as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term . . . . or upon the surrender of the contract." The latter of the two quotations represents a change from the law of 1913 which exempted "payments made by, or credited to the insured, on life insurance, endowment, or annuity contracts, upon the return thereof to the insured at the maturity of the term mentioned in the contract, or upon surrender of the contract." The sections quoted apparently intend to exempt from taxation all life insurance *paid to beneficiaries* at the death of the insured; and all insurance endowments or annuities *paid to the insured*, in so far as the latter represent a "return of premium or premiums." Another section of the law states that "All persons, firms, ... and insurance companies . . . . having the control, ... or payment of interest, ... *annuities* . . . . or other fixed or determinable annual or periodical gains, profits and income of another person, exceeding $3,000 for any taxable year . . . . are . . . . required to deduct, and withhold . . . . such sum as will be sufficient to pay the normal tax imposed." The question now arises whether an annuity exceeding $3,000 to a single person, or an installment payment of like amount, is subject to income tax before payment. The 1916 law must be interpreted largely on the basis of the rulings made by the Treasury Department under the law of 1913, since the first returns under the new statute are not due until March 1, 1917. In reply to inquiries concerning the taxation of gold bonds, continuous installment contracts, and ordinary policies settled under options 2 and 3 of the New York contract the revenue authorities ruled[6] that "the proceeds of insurance policies paid pursuant to contract are held not to be taxable in the hands of the beneficiaries, hence in the payment of such proceeds, whether the same be in a lump sum or in installments, at the death of the insured, on a matured policy or as annuities, no withholding of the tax is required." A later ruling of the Treasury Department (T. D. No. 2152, Feb. 12, 1913) states that "The amount paid under a life insurance, endow-

[6] Quoted from an article by John S. Thompson on "Income Tax on Annuities" in *Transactions Actuarial Society of America*, 16: 95–108. The reader is referred especially to this paper for a full discussion of the rulings.

ment, or annuity contract is not income *when returned to the person making the contract*[7] either upon the maturity or the surrender of the contract; but the amount by which the sum received exceeds the sum paid and coming into the hands of the person making the contract and payment is income."

The writer, being in doubt as to the interpretation of these rulings, addressed an inquiry to the Commissioner of Internal Revenue and received the following reply on January 11, 1917:

> The Federal Income Tax Law of September 8, 1916 does not impose a tax on the proceeds of a life insurance policy paid, on the death of the insured, to an individual beneficiary, whether paid as a lump sum or in installments.
>
> In a case where, under the terms of an endowment, or other form of life insurance policy, the insured receives upon maturity of the contract the face value of the policy with or without accumulations, the difference between this amount, plus all other amounts of income received on the policy during its life, and the aggregate amount of premiums paid, constitutes taxable income which should be included in any personal return the individual may be required to render for the year during which the final proceeds of the policy are received.
>
> If under the terms of a matured insurance policy, the insured receives annual payments of income, they need not be returned for Federal income tax purposes until the aggregate amount of such payments received equals the amount of premiums paid. In short, the amount by which the proceeds received by the insured on a life insurance policy exceeds the actual cost of a policy to him constitutes taxable income in his hands.

According to these decisions, insurance, endowment or annuity contracts *paid to beneficiaries upon the death of the insured* are not taxed at all, no matter whether paid in a lump sum, in installments, or as a life annuity; but like contracts paid to the insured are taxed on the amounts received in excess of the purchase money. Thus, an annuity for $10,000 purchased at a cost of $100,000 by a person for himself is not taxed until after ten payments of $10,000 have been made. Thereafter, it is taxed as any other income of $10,000. An endowment for $100,000 face value enables the company to pay the insured ten annual installments of $11,300. No tax is assessed against these installments until the insured has received $100,000 in full; the remaining payments are taxed the same as other income.

It was for the inclusion of these paragraphs in the law, exempt-

[7] The italics were not in the original.

ing the proceeds of life insurance policies from the income tax, that the insurance companies fought so hard in 1913. Of the desirability of exempting such proceeds from the tax, when paid in a lump sum in full settlement of the contract there can be no question. As previously stated, this fund should be taxed only as an inheritance. But for the illogical distinctions between policies paid to the insured and policies paid to beneficiaries; or between income representing a repayment of purchase money and income beyond this amount, in the case of installments or annuities, there is not adequate justification. The distinction that requires emphasis is between small incomes and large; between the income that just satisfies the demands of a decent standard of living, and the income far in excess of this amount. Relief granted from the income tax should not be a means of escape from taxation by persons of great wealth; but under the present law, as interpreted, it is just that. It matters not how great the amount of the annuity, if paid to a beneficiary it is not taxed; and if paid to the insured it escapes taxation for a number of years. An annuity is an income for life; it involves, in the words of an English court,[8] "the conversion of capital into income and reasonably enough, *when the buyer places himself in that position* the Act taxes him; he is taken at his word, he has got an income secured in the way mentioned." Such might better be the interpretation of the American Act. The claim for the exemption of insurance funds from income taxation is based on the eminently just grounds that adequate provision for necessary insurance *needs* should be encouraged. Let the law not then be used as a means of evasion by those who "have ability to pay." In their eagerness to grant necessary and proper relief to policyholders, life insurance officials have been caught in a dangerous position by this provision of the law. Their only safety lies in a thorough analysis of necessary life insurance needs and in a demand that special consideration be given to persons who meet those needs by the expenditure of their personal incomes.

SUMMARY OF FEDERAL AND STATE TAXATION

The federal tax law thus has its weakness and its strength in the way it meets the requirements of a scientific tax on life insurance funds. The tax on the income of life insurance corporations is

[8] Secretary of State for India *v.* Scoble (1903) 4 Tax Cas. 622, per Mathew, L. J., quoted in Pratt and Redman's *Income Tax Law* (ed. 1916), p. 156.

based on the indisputable fact that their assets reflect, in the case of many policyholders, more than a liberal *minimum* provision for life insurance needs; the excise tax is levied only on the capital stock of corporations for profit, and does not affect purely mutual companies. From neither of these levies is there any logical escape. The income tax on individuals presents the weak side of the law in its most pronounced form. It offers no relief from the tax for income spent on insurance and annuities and thereby fails to give desirable encouragement for supplying these socially important needs; and in the relief which it grants to persons in receipt of the proceeds of insurance policies it violates the necessary distinction between large and small incomes, and opens the way for evasion of taxation by persons of wealth who invest large sums in insurance or annuity contracts.

State taxes are equally unscientific in their incidence on life insurance. The easy solution, to allow the states to collect taxes equal to the cost of supervision and to retain all general taxation for the federal government, neglects the fact that the states are already taxing the companies in amounts far greater than the cost of supervision, that they will not relinquish their present hold on the companies, and that they are performing general governmental functions in only lesser degree than the federal government. It would be desirable, were it possible, for the states to confine license, premium and asset taxation to the payment of supervision costs and to use income and inheritance taxes for general taxation purposes. This would give greater opportunity than exists under the present system to introduce scientific tax methods.

THE TAXATION OF LIFE INSURANCE IN ENGLAND

English practice in the taxation of incomes furnishes points of contrast and points of similarity to the situation in the United States. Life insurance companies in England are taxed upon their "profits or gains" and these may be assessed upon "trade profits" or upon interest on investments. The Crown has the right to elect under which method to assess, and usually selects the latter as most profitable because of the large reserves held. The assessment on trade profits is, of course, possible only with stock companies, since the members of mutual companies do not trade between themselves. Trade profits may include the dividends paid on participating poli-

cies, but where the tax is levied on the investment income of a mutual company no part of the surplus accruing from premiums is taxable (Last *v.* London Assur. Corp'n 1885, 10 App. Cas. 438; Equit. Life Assur. Soc. of U. S. *v.* Bishop 1900, 1 Q. B. 177; New York Life Ins. Co. *v.* Styles 1889, 14 App. Cas. 381). The English method of taxing the income of companies is thus similar to the American, with the exception that the latter does not tax dividends in any case.

The English law furnishes its great contrast to ours in the method of taxing individual incomes. In addition to complete relief for incomes under £130 and a sliding scale tax for incomes from £130 to £700, an allowance is made for life insurance premiums. It covers annual premiums paid by the insured for insurance or deferred annuities on his life or the life of his wife; and the annual sums paid by a person or deducted from his salary under any act of Parliament for a deferred annuity for his widow or for provision for children after his death. Three limits are set to the amount of income thus exempt from tax—premiums up to one-sixth of his income; premiums up to seven per cent of the sum insured; and premiums not totalling more than £100. The last two limitations form part of the Finance Act of 1915. With complete personal exemption for all incomes up to £130, the English Act thus allows additional relief to £100, if spent on necessary life insurance protection. The method of relating this relief to *needs* (covering protection to self, wife or dependent children) is noteworthy. Were the American Act to do the equivalent, on the basis of the $4,000 exemption for married men, it would enable them to spend nearly $3,100 more in insurance premiums before they were taxed.

The term "annuity" is used with many different meanings in the English Act and in court decisions. Thus annuities purchased are distinguished from annuities by will or settlement, or annuities in the nature of a pension. The latter two classes are taxed to their full amount as income. The word "annuity" in the former case is sometimes used in an ambiguous sense: it may represent the repayment of a debt by installments, or the conversion of capital into income. In a much quoted decision in which this distinction is made, this statement appears: "An annuity, in the ordinary sense of the word, means the purchase of an income. It generally involves the conversion of capital into income, and reasonably enough, *when the buyer places himself in that position* the act taxes him; he is

taken at his word, he has got an income secured in the way mentioned."[9] This decision unquestionably covers annuities purchased from life insurance companies, and in conformity with it, such annuities are taxed in England in the same way as other income.

In its taxation of personal incomes the English law thus stands in striking contrast to our own; for it allows the holders of large annuity contracts no opportunity to evade their just share of tax burdens, and it tends to encourage the purchase of insurance protection by those who need it.

[9] Secretary of State for India *v.* Scoble 1903, 4 Tax Cas. 622, quoted from Pratt & Redman's *Income Tax Law* (ed. 1916), p. 156.